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TREASURY FOR KLINGENSMITH AND NGRANT
COMMERCE FOR 4431/MAC/WH/MCAMERON
NSC FOR DTOMLINSON
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TAGS: ECON EFIN VE
SUBJECT: BONOS DEL SUR: ROUND 2

REF: A. 06CARACAS 3375

¶B. 06CARACAS 3434
¶C. 06CARACAS 3653
¶D. CARACAS 387

¶1. (SBU) SUMMARY: Venezuela will issue another round of the "Bonos del Sur" on March 8 worth USD 1.5 billion. Preliminary reports indicate that the issuance is more than nine times oversubscribed. Demand for these Venezuelan-Argentinian bonds is well ahead of supply, as the Argentinian half offers an outlet to dollars at an implicit rate well below the current parallel market rate. The issuance will do little to help with Venezuela's liquidity problems. In keeping with the irony that is "Socialism for the 21st Century," this issuance will help a populist ally of Venezuela's, enrich a small group of middle to upper class Venezuelans, and do little to fix the mounting economic distortions prevalent in all sectors of the economy. END SUMMARY.

¶2. (U) Following the announcement by Chavez during Kirchner's visit in February (reftel D), the Minister of People's Power for Finance (MPPF) Rodrigo Cabezas announced the issuance of another round of "Bonos del Sur" on February 26. The USD 1.5 billion issuance will occur on March 8 and trading will begin on March 9, in a manner similar to the first issuance this November (reftel A). The bonds have two halves: the Venezuelan half is made up of BRV Secured Interest and Principal Certificates (TICCs) that mature on March 21, 2019 and pay 5.25 percent interest and the other half is an Argentine bond (Bonden 15) which matures on October 3, 2015 and pays 7 percent interest. The TICCs are protected against inflation and devaluation and pay interest in Bolivars. The Bonden 15s are dollar-denominated and are convertible to dollars on international markets. The MPPF will sell the bonds at 112.6 percent of value.

¶3. (SBU) The Argentine half drives the demand for this instrument as exchange controls in Venezuela make it difficult to obtain dollars. In addition, the bonds will be sold at an implicit rate of over 2800 Bolivars/dollar, which is 30 percent above the official exchange rate of 2150 Bolivars/dollar, though significantly less than the current parallel rate above 4000 Bolivars/dollar. Given the arbitrage between the implicit rate of the Bono del Sur and the value of dollars in the parallel market, anyone lucky enough to obtain a bond can make an immediate return of more

than 40 percent on the Argentine half. The TICCs will mostly be sold off to local financial institutions, who desire these instruments to protect against inflation and provide tax-free interest payments.

¶4. (SBU) As was the case with the previous issuance in November, MPPF announced that priority would be given to small investors and it is likely that people will only get a portion of their request. According to Cabezas' statement, requests of under USD 5000 will be fulfilled and those over USD 5000 will get between USD 5000 and USD 8000, depending on the size of the request. A local banker told the DCM that his bank processed "dozens" of million dollar buy orders, including one USD 20 million order, all of which will apparently get the maximum USD 8000 allocation. Anxious buyers tried other methods, including some that collected national identification numbers from their friends and family members to make multiple submissions for bonds, in the hopes of increasing their total allocation.

¶5. (SBU) While the issuance is a boon for the "small investors" who obtain bonds, it will do little to help lower the gap between official and parallel rates. Sintesis Financiera, a respected economic consulting firm, recently estimated that it would take as much as USD 6 billion in issuances to stabilize the parallel rate (bringing it back to the 2005-2006 level of 20-30 percent above the official rate).

¶6. (SBU) The demand for parallel dollars has grown since December, when the Commission for the Administration of Foreign Exchange (CADIVI) instituted a new requirement for importers to obtain certificates from the Ministry of People's Power for Agriculture (MPPA) and Ministry of People's Power for Industry and Light Commerce (MPPILCO) to show that the goods they request dollars to import are not produced locally or that local supply is insufficient (reftel C). MPPILCO, in particular has been very slow in issuing these certificates, forcing many firms to use the parallel market to obtain dollars. CADIVI remains a problem for companies seeking to repatriate profits or dividends and they also have been using the parallel rate to make up for the insufficient supply from CADIVI. This is despite the fact that CADIVI approvals have increased of late, and in 2006 CADIVI authorized USD 27.4 billion in foreign exchange transactions, up 32 percent from 2005.

¶7. (SBU) In addition, the added political and economic uncertainty following the series of announcements by Chavez and BRV officials at the beginning of the year have pushed many individuals and companies to try to get their money out of the country. By targeting the allocations for small investors, the MPPF is providing an immediate profit for them, yet doing nothing to meet the needs of the companies and institutional investors driving the demand in the parallel market. Minister Cabezas announced on March 4 that the bonds had been oversubscribed by over nine times. As was the case previously, the parallel rate may actually increase as the issuance stimulates demand by those who expected to obtain more bonds and thus have unmet foreign currency needs (reftel B).

¶8. (SBU) During an interview on March 4, Cabezas indicated that the proceeds would be used to pay off old debt, and not for spending. Cabezas predicted that up to 40 percent of Venezuela's external debt would be refinanced this year, mostly by replacing external, dollar-denominated debt with local debt in Bolivars. This will place less pressure on the country's foreign exchange reserves and make future devaluation or default less painful as they will be dealing mostly with local creditors. Including USD 750 million for the Bonos del Sur, Venezuela has purchased approximately USD 4.4 billion in Argentine bonds over the past two years, which has been financed through the National Development Fund (FONDEN).

¶9. (SBU) COMMENT: This is the first debt issuance of 2007 and more are likely to follow. PDVSA is still planning to issue

up to USD 3.5 billion in bonds, though it appears this issuance will be only in Bolivars and targeted to the local market. Estimates are that the BRV will once again go into deficit spending this year as oil prices and production evens out or even falls from 2006 levels while spending and inflation continue to grow. Estimates of the BRV's financing needs for 2007 range widely, from USD 5 billion to USD 25 billion. In the end, Bonos del Sur II will be more of a PR ploy than real economic policy. The government will claim that it has intervened to lower liquidity, reduce inflation, help out small investors, and maintain solidarity with an important ally. In reality, it will have enriched tens of thousands of (already wealthy) Venezuelans and purchased some Argentine goodwill, the price of which seems to continue to increase. END COMMENT.

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